Nos. 667-670

DEC 15

CHARLES ELMORE

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

WESLEY W. WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

J. MARION WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

ESTATE OF J. M. WEST, DECEASED,
JAMES M. WEST, JR., ET AL., EXECUTORS, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

JESSIE GERTRUDE WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

RANDOLPH E. PAUL,
J. ARTHUR PLATT,
JAMES H. YEATMAN,
Counsel for the Petitioners.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

The Petitioners, Wesley W. West, J. Marion West, Estate of J. M. West, Deceased, James M. West, Jr., et al., Executors, and Jessie Gertrude West,[1] pray that a writ of

[1] The proceedings involving the above entitled petitioners were consolidated with that of Wesley W. West in the Tax Court (R. 20), in the Circuit Court of Appeals (R. 324) and in this Court (R. 356) and only one record has been printed covering the consolidated cases *sub nom. Wesley W. West* v. *Commissioner of Internal Revenue*.

certiorari be issued to review the decision of the Circuit Court of Appeals for the Fifth Circuit in the above case.

OPINIONS BELOW.

The opinion of the Tax Court of the United States (R. 236 to 281) is reported in 3 T. C. 431. The opinion of the Circuit Court of Appeals for the Fifth Circuit (R. 331 to 344) is reported in 150 F. (2d) 723.

JURISDICTION.

The judgments of the Circuit Court of Appeals were entered on July 24, 1945. (R. 344). An order was promulgated by the Circuit Court of Appeals dated Aug. 3, 1945 (R. 348) granting an extension of time for filling a petition for rehearing until September 11, 1945. Pursuant to this order, the petitioners filed a petition for rehearing (R. 349) on September 8, 1945. The petition for rehearing was denied by the Circuit Court of Appeals by an order dated September 18, 1945. (R. 353, 354) The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925, c. 229, 43 Stat. 936, Title 28 U. S. C. § 347.

QUESTIONS PRESENTED.

1. Whether the conveyance of the petitioners' lands under a general warranty deed and contract of December 28, 1938, including portions of the minerals thereunder constituted a sale of capital assets within the meaning of Section 117 of the Revenue Act of 1938, or whether the transaction was a sale of the surface of the land and the mere leasing of the minerals.

2. Whether the Tax Court's conclusion concerning the legal effect of the transaction and its interpretation and application of Section 117 of the Revenue Act of 1938 is final and binding upon review.

STATUTE INVOLVED.

The Statute involved is Section 117 of the Revenue Act of 1938, c. 289, 52 Stat. 447.

"Sec. 117. CAPITAL GAINS AND LOSSES.

(a) DEFINITIONS.—As used in this title—

* * * * *

(4) LONG-TERM CAPITAL GAIN.—The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such gain is taken into account in computing net income;

* * * * *

(b) PERCENTAGE TAKEN INTO ACCOUNT.—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income;

* * * * *

50 per centum if the capital asset has been held for more than 24 months.

(c) ALTERNATIVE TAXES.—

(1) IN CASE OF NET LONG-TERM CAPITAL GAIN.—If for any taxable year a taxpayer (other than a corporation) derives a net long-term capital gain, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 11 and 12, a tax determined as follows, if and only if such tax is less than the tax imposed by such sections:

A partial tax shall first be computed upon the net income reduced by the amount of the net long-term capital gain, at the rates and in the manner as if this subsection had not been enacted, and the total tax shall be the partial tax plus 30 per centum of the net long-term capital gain."

STATEMENT OF FACTS.

Deficiencies[2] of income tax were asserted against the petitioners for the tax year 1938. They arose out of a transaction in which on December 28, 1938, petitioners, for a cash consideration,[3] conveyed to Humble Oil & Refining Company, herein called "Humble," by general warranty deed the fee simple title to certain lands and minerals they had owned for more than two years.[4] The property conveyed comprised: (1) the 200 acre homestead tract of J. M. West and Jessie Gertrude West, together with a portion of the minerals thereunder, in which the other petitioners had no interest; (2) 22,955.60 acres of other land and a portion of the minerals thereunder; and (3) a portion of the minerals only in 70.67 additional acres of land. (R. 239). There was one producing oil well, one producing gas well and one well being drilled by petitioners at the time of the consummation of the sale. (R. 256). The petitioners did not convey all of the minerals in the lands but excepted from the conveyance

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[2] The amounts were as follows:

Wesley W. West	$713,494.14
J. Marion West	727,191.99
Estate of J. M. West	371,978.10
Jessie Gertrude West	371,978.10

(R. 237)

Upon computation under Rule 50 of the Tax Court the deficiency of Wesley W. West was found to be $642,711.97 (R. 310) by reason of certain adjustments not now in issue. No similar computation for the other petitioners is contained in the record.

[3] The cash payment was $8,032,145.26 (R. 257) and included payments to the charitable foundation and a payment of $65,000 (R. 257) for the assignment of two leases (covering minerals in other lands) which are not here in question. Certain improvements including oil improvements upon the land were also conveyed (R. 238). There is here no controversy concerning the tax treatment of the improvements as such.

[4] J. M. West was then alive and a charitable foundation not here involved was also a grantor. For purposes of convenience, however, the grantors will be referred to as the petitioners.

and kept for themselves a fractional interest in the minerals.[5]

Contemporaneously with the execution of the deed, the petitioners executed a contract (R. 238) with Humble in which Humble assumed certain obligations designed to protect the petitioners' retained mineral interests. These obligations included the operation of two drilling rigs in each of the two known fields until there was one well for each twenty acres of producing land (R. 245-246); the reasonable development of those lands not included in the two fields in the event oil was discovered in paying quantities upon them (R. 247, 248); the drilling of five 10,000 foot test wells upon the petitioners' request, within certain of the areas involved, five years after the known fields had been developed to the minimum extent required (R. 248, 249, 251-253). Appropriate division orders were executed providing for the allocation of the oil produced to the several owners. (R. 256, 257).

In their income tax returns the petitioners reported the gain realized as gain from the sale or exchange of capital assets under Section 117 of the Revenue Act of 1938,[6] the gain being measured by the difference between the cost of the properties conveyed and the consideration received. (R. 258). The Commissioner held that the conveyance was a sale of the surface of the land but only a lease of the minerals therein, and that so much of the consideration as was allocable to the minerals conveyed should be treated as a lease bonus subject to the depletion allowance rather

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[5] The mineral interests not conveyed were: 3/8 of all the oil produced and saved from those portions of the land which were included in the Friendswood and Clear Lake oil fields from a depth of not more than 7,500 feet; 1/4 of the oil produced and saved from the portion of the land which was not included in the same two fields and produced from a depth of not more than 7,500 feet; 3/16 of all oil produced from all the land from a depth of more than 7,500 feet (R. 253). The mineral interests not conveyed were reduced in cases where tracts which had been purchased by the petitioners subject to mineral interests retained by previous owners. (R. 243, 244.)

[6] It was stipulated that the lands and minerals sold were capital assets. (R. 30, 31.)

than as capital gain taxable at capital gain rates. (R. 259). The Tax Court sustained the Commissioner[7] (R. 275) and the Circuit Court of Appeals affirmed the Tax Court's decision.[8] (R. 337).

Neither the deed (Ex. 1, R. 36) nor the contemporaneous contract (Ex. 2, R. 92) contained any provisions for forfeiture, reversion, or any other terms limiting in any way the fee simple estate conveyed to Humble. The limited obligations assumed by Humble in no wise affected the title conveyed.

SPECIFICATION OF ERRORS TO BE URGED.

The Circuit Court of Appeals for the Fifth Circuit erred:

1. In determining that the transaction amounted to a lease of the minerals notwithstanding there was a sale of the surface of the land.

2. In affirming the holding of the Tax Court that the tax liability arising from the sale and conveyance of the minerals was not determined by the capital gain provisions of the Revenue Act.

3. In deciding that there was substantial evidence to support the holding of the Tax Court that the conveyance was a lease of the minerals.

4. In deciding, in substance, that the interpretation and effect given the conveyance by the Tax Court and the application thereto of Section 117 of the Revenue Act was binding upon the Circuit Court and not subject to review.

5. In holding, in effect, that the conclusion of the Tax Court as to whether the conveyance constituted a "sale" of the minerals within the meaning of Section 117 of the Revenue Act of 1938, was a finding of fact that was binding upon the Circuit Court on review.

6. In affirming the decision of the Tax Court.

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[7] Two judges dissenting.

[8] One of the three judges dissenting.

REASONS FOR GRANTING THE WRIT.

I. The question involved is an important question of federal law which has not been, but should be, decided by this Court.

The immediate question involved has never been considered by this Court nor by any of the Circuit Courts of Appeals (except in the instant case) despite the fact that in Texas and other oil producing areas it is customary for landowners to retain a mineral interest when they sell their land.[9] This widespread practice has not hitherto led to tax litigation because it has been assumed by sellers, and apparently by the Commissioner, that sales of land were "sales" for tax purposes irrespective of the retention of a portion of an interest in the minerals (a royalty). Those who have made such sales in the past and those who may make such sales in the future do not now know (1) whether the sales are in no case to be treated as sales of capital assets; (2) whether they are to be treated as sales only if minimum development to the extent of that here present is contractually provided for; or (3) whether a lesser provision for development will carry with it similar tax results.[10]

In view of the large number of taxpayers affected and the widespread uncertainty created by the decision of the Circuit Court of Appeals, the basic question should authoritatively be answered by this Court.

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[9] The reason for the growth of this custom is found in the impossibility of achieving a fair lump sum selling price for potential mineral producing land in the absence of any inexpensive and precise method of determining the probable mineral content of the area. Landowners, accordingly, seek to gain for themselves at least a portion of benefits of minerals which may be discovered by retaining a portion of them in the form of a royalty.

[10] The brief of Commissioner in the Circuit Court of Appeals in the case at bar argued that in any instance where the owner of minerals sells less than all the minerals the transaction is a lease and not a sale. (Commissioner's brief pp. 21, 22.) Moreover, the Commissioner's agents are, upon the authority of the decision of the Tax Court in this case, holding that where any mineral interest is retained by the vendor, with or without contractual covenants of development, the transaction is a lease and not a sale.

II. The decision of the Circuit Court of Appeals is in conflict with the principles laid down by this Court in related cases.

This Court has, in a number of cases, considered and delineated the tax consequences of certain types of relationships also commonly found in this industry between landlord and tenant, tenant and subtenant, and tenant and assignee.[11] In these cases this Court has allowed the statutory depletion deduction to those retaining the capital investment in minerals in place and has laid down the basic principles upon which cash payments, oil payments and royalties are to be treated as payments for capital assets or as the return for the exploitation of a retained mineral interest (i.e. rent) in varying circumstances. The principles laid down in these cases have not been followed by the Circuit Court of Appeals in its determination of the present case.

In *Burnet* v. *Harmel*[12] this Court stated that a bonus payment upon the execution of an oil lease is merely an advance royalty similar to advance rent and derives its character (whether a payment for a capital asset or ordinary income) from the nature of the transaction. The Court emphasized[13] that an oil *lease* was not a sale of oil and gas because the lessee acquired the privilege to exploit the land for only a "prescribed period" and because at the termination of the lease all unabstracted minerals would remain the property of the lessor. The Circuit Court held the cash payment here an advance royalty even though Humble acquired a fee and not the privilege of exploitation only for a "prescribed period" and even though there could be no termina-

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[11] E. g. *Burnet* v. *Harmel*, 287 U. S. 103 (1932); *Palmer* v *Bender*, 287 U. S. 551 (1933); *Herring* v. *Commissioner*, 293 U. S. 322 (1935); *Thomas* v. *Perkins*, 301 U. S. 655 (1937); *Helvering* v. *Elbe Oil Development Co.*, 303 U. S. 372 (1938); and *Anderson* v. *Helvering*, 310 U. S. 404 (1940), the only case involving the transfer of a fee interest.

[12] *Supra*, p. 106.

[13] *Supra*, pp. 107, 111.

tion of the estate granted to Humble and there was no accompanying right of reversion of unabstracted minerals in the petitioners.

Subsequent cases have applied the basic concept in a variety of circumstances, but it has been unaltered.[14] In no case has a cash payment upon the transfer of a fee interest been held to be a bonus upon which the depletion allowance may be taken. All the decided cases indicate that such a payment is not subject to the depletion allowance, from which it follows that the payment is for the sale of the mineral interest. The decision of the Circuit Court of Appeals is, therefore, in conflict with the basic principles laid down by this Court in the cognate fields of depletion allowances and capital gains (or losses).

III. The decision of the Circuit Court is in conflict with principles laid down by the Ninth Circuit in related cases.

The Circuit Court of Appeals for the Ninth Circuit has decided two cases[15] in which was presented the closely related question whether certain transfers were outright transfers of mineral interests when the owner had purported to lease them, reserving a percentage of the net profits for the term of the lease. The Circuit Court of Appeals for the Ninth Circuit held that the landowner had not trans-

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[14] Thus in *Palmer* v. *Bender*, *supra*, a cash payment upon the assignment (or sublease) of a lease by the lessee, who also retained a royalty for the duration of the lease, was considered an advance royalty. This royalty, like that in the *Harmel* case, was considered ordinary income rather than the proceeds of a sale because it was made to acquire the right to exploit the land for a prescribed period. See also *Herring* v. *Commissioner*, *supra*, p. 324. In *Anderson* v. *Helvering*, *supra*, p. 409, it is stated that cash bonus payments "when included in a royalty *lease*" (emphasis supplied) are given the same consequences as royalties. *Helvering* v. *Elbe Oil Land Co.*, *supra*, p. 376 makes it plain that payments received "from the sale of oil and gas properties themselves" are not subject to a depletion allowance.

[15] *Commissioner* v. *Felix Oil Co.*, 144 F. (2d) 276 (C. C. A. 9th, 1944); *Commissioner* v. *Crawford*, 148 F. (2d) 776 (C. C. A. 9th, 1945), certiorari granted October 8, 1945.

ferred outright the mineral interest notwithstanding the net profits reservation.[16] In reaching this conclusion in the *Felix Oil Company* case, which was followed in the *Crawford* case, the Circuit Court emphasized that the owners therein had retained reversionary rights, the right of forfeiture for breach of conditions, and the right, upon the termination of the lease, to accede to certain equipment placed upon the property by the lessee.

The Circuit Court of Appeals for the Ninth Circuit felt that these distinctive rights of ownership were determinative of the nature of the transaction and the character of the payments made thereunder even where, according to its reasoning, a portion of the economic interest retained by the lessor was measured with reference to net profits. The Commissioner contended in this Court[17] that it is the particular provision for payment, not the form of transfer, which is determinative of the proper tax treatment of the payments. Or, stated otherwise, the character of the interest which is actually transferred, as opposed to the form of the operative instrument, must necessarily determine the nature of the payments for tax purposes. This is the case in every other form of transaction.[18] In the *Kirby* and *Crawford* cases it may be determined that the lessors did or did not transfer their economic interest in the minerals attributable

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[16] The majority of the Circuit Court of Appeals for the Fifth Circuit came to the opposite conclusion in *Commissioner* v. *Kirby Petroleum Co.*, 148 F. (2d) 80 (C. C. A. 5th, 1945), certiorari granted May 21, 1945, presumably partially, at least, upon the ground of conflict with *Commissioner* v. *Felix Oil Co.*, *supra*.

[17] Commissioner's brief in this Court in *Kirby Petroleum Co.* v. *Commissioner*, *supra*, p. 15.

[18] For example, in the transfer of non-mineral lands, if the interest transferred is the right to occupy the property for a term of years, the payments made, irrespective of what they are designated or of how they are measured, are considered rent. If the interest transferred is what would be called a fee, the payments are considered payments for a capital asset even though they may be made over a large number of years. Payments are neutral in themselves and take their character from the nature of the interests transferred in the transactions which generate the payments.

to the lessor's right to share in net profits for purposes of determining the depletion allowances.[19] But it is significant that the Circuit Courts of Appeals did not hold that and the Commissioner does not contend that the payments made under the profit sharing arrangement should be treated as capital gain upon the sale of a portion of minerals in place. Presumably this contention is not made and the Circuit Courts did not so hold because the payments measured by net profits still take their character from the generating transaction. This transaction was a transfer of the right to exploit the lands for a limited period of time and upon the termination or forfeiture of the lease, unmined minerals would revert to the lessors.[20] The interest transferred in the case at bar was not of this character but that permanent right of use and possession known as a fee.

The petitioners here retained none of the above listed distinctive rights of ownership. The holding of the Circuit Court of Appeals for the Fifth Circuit in the instant case that the petitioners had leased the mineral interest is accordingly in conflict with the principles laid down in closely related cases by the Circuit Court of Appeals for the Ninth Circuit.

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[19] It is the Commissioner's position upon this point that the lessors retained no depletable interest because the right to share in profits does not constitute gross income from oil and gas property upon which the depletion deduction is allowed. (Commissioner's brief in *Kirby Petroleum Co.* v. *Commissioner*, *supra*, in this Court, pp. 26, 27.)

[20] If this is not the reason, the Commissioner is taking the position that there can never be a sale of a portion of a mineral interest. In other words, in any case in which the grantor of minerals retains an interest in a portion of the minerals his mere retention of an interest in a portion of the minerals has the effect of preventing sale of another portion of the minerals from being regarded as such. We cannot believe that this was ever intended by Congress or by this Court since it is well recognized that sales of a percentage interest in minerals are common transactions.

IV. The Circuit Court's decision is in conflict with this Court's decision in Trust u/w of Mary Lily (Flagler) Bingham v. Commissioner.

The Circuit Court appears to take the view that the Tax Court's conclusion that the transaction amounted to a lease of the minerals is a determination of "fact" which is binding upon the reviewing court. The determination of this so-called fact required the Tax Court to come to two legal conclusions: (1) to place a given transaction in one of two well-recognized legal categories, a lease or a sale; and (2) to decide that the transaction was not a "sale" within the meaning of Section 117 of the Revenue Act of 1938.[21] Such legal conclusions are clearly within the scope of proper judicial review of the Tax Court and any doubt which may have previously existed upon the subject[22] is considerably dissipated by *Trust u/w of Mary Lily (Flagler) Bingham* v. *Commissioner*.[23] The Tax Court here has announced a rule of general applicability and the facts upon which it is based fall short of the statutory requirement. Cf. *Powers* v. *Commissioner*.[24] The Circuit Court in holding that the Tax Court's determination that the minerals were leased was a

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[21] To state the ultimate situation more accurately, the Tax Court came to only one legal conclusion, that the transaction did not amount to a "sale" as that term is ordinarily employed in the law for it is well established that the term "sale" in the Revenue Acts is to be given its usual meaning. *Burnet* v. *Harmel, supra; Fairbanks* v. *United States*, 306 U. S. 436 (1939).

[22] Cf. *Dobson* v. *Commissioner*, 320 U. S. 489 (1943), rehearing denied, 321 U. S. 231 (1944).

[23] 65 S. Ct. 1232, decided June 4, 1945.

[24] 312 U. S. 259 (1941). In this case the question involved was that of value, a question traditionally considered a question of fact. Upon review it was determined that the Board of Tax Appeals had employed an improper criterion in making its findings. The criterion to be used in determining the value of a given type of property is considered a rule of general applicability and a question of law even though the fixing of value is said to be a finding of fact.

"fact"[25] has failed to perform its duty to review questions of law as that duty has been defined by this Court in the *Bingham* case.

CONCLUSION.

For the foregoing reasons it is respectfully submitted that this petition for a writ of certariori should be granted.

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[25] If this determination is a finding of fact, it is not supported by substantial evidence. The evidence consists principally of the deed and the contract and they lend no support to the view that the transaction was a lease of the minerals.